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DEALING WITH NPL IN EUROPE

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- AS SUGGESTED BY MR. INGVESS, HERE IS A BRIEF SELF INTRODUCTION

- AFTER 12 YEARS IN SENIOR POSITIONS IN COMMERCIAL BANKING, I HAVE DEVOTED 40 YEARS WORKING HANDS-ON IN PROBLEM BANKS IN 4 CONTINENTS. THIS INCLUDES 9 YEARS WITH THE SPANISH FDIC (BOTH DEPOSIT INSURANCE AND BAD BANK) AND THE BANK OF SPAIN (AS HEAD OF BANKING SUPERVISION), DEALING WITH THE CRISIS OF THE 80'S. LATER, I SPENT 3 YEARS WITH THE WORLD BANK AND 28 YEARS FROM MY CONSULTING PRACTICE, WHERE I SHALL DIE WITH MY BOOTS ON

- NOW, DOWN TO THE TOPIC

- GOOD NEWS. THE PROBLEM OF NPL SEEMS TO BE ADDRESSED FOR GOOD

- BAD NEWS. THE LEGACY OF NPL IS STILL A SERIOUS PROBLEM IN A NUMBER OF SIGNIFICANT BANKS. AFTER 10 YEARS OF CRISIS AND REMEDIAL REGULATION, PARADOXICALLY, MOST BANKS SHOW A SATISFACTORY LEVEL OF REGULATORY CAPITAL IN THE BOOKS. I APOLOGIZE, BUT I DARE SAY THAT SOMETHING SOUNDS WRONG

- OF COURSE, WHAT HAS BEEN DONE IN THESE 10 YEARS IS DONE. IT IS HISTORY. BUT WHEN ADDRESSING THE FUTURE WE SHOULD LEARN FROM EXPERIENCE. THE LESSON TO BE DRAWN COULD BE THAT REGULATORS HAVE FOCUSED STRONGLY ON CAPITAL – WHICH IS GREAT – BUT THEY HAVE NEGLECTED PREVENTIVE MEDICINE TO REDUCE THE NUMBER OR SIZE OF

CRISES, WHERE DEALING WITH NPL PLAYS A KEY ROLE. THIS IS THE CORE OF MY MESSAGE TODAY ON NPL

- AS A SUPPORTING BACKGROUND FOR MY SUGGESTIONS, BASED ON MY EXPERIENCE, I WILL FIRST LIST A SERIES OF RULES OF THUMB OR OPINIONS OF MY OWN, WHICH ALSO CONVEY A POSITIVE OR LESS POSITIVE EVALUATION OF THE CURRENT CONVENTIONAL WISDOM IN THIS AREA:
 1. ANY REGULATION (SUCH AS CAPITAL OR ASSET QUALITY) BASED ON UNVERIFIED INFORMATION PROVIDED BY BANKS IS LIKELY TO PROVE INEFFECTIVE OR MISLEADING. THIS INCLUDES OFF-SITE ANALYSIS, AUDITING, MODELS, STRESS TESTS AND RWA MECHANISMS. WHY? BECAUSE PROBLEM BANKS HIDE THEIR PROBLEMS WITH ACCOUNTING GIMMICKS, OFTEN - BUT NOT ONLY - BY RESTRUCTURING AND REFINANCING BAD LOANS
 2. HOW COME? THE WORST LOANS (BY SIZE AND RISK) WILL BE DISGUISED AS GOOD ONES AND WILL NEVER BE RECORDED AS BAD IN THE BOOKS OR PROVISIONED. AS A RESULT, EXPECTED LOSSES WILL NOT HAVE A SPECIFIC COVERAGE AND, OF COURSE, CAPITAL ON THE BOOKS WILL BE FICTITIOUS. REAL CAPITAL IS CAPITAL AS PER BOOKS MINUS INSUFFICIENT PROVISIONS. LET ALONE THE POOR QUALITY COMPONENTS OF REGULATORY CAPITAL
 3. THAT IS WHY THE KEY TO PRUDENTIAL SUPERVISION IS REALISTIC ASSET EVALUATION. BUT, MIND YOU, FOR ASSET EVALUATION TO PROVE REALISTIC, IT SHOULD BE PERFORMED BY MEANS OF ON-SITE INSPECTION AIMED TO IDENTIFY THE MARKET VALUE OF FORECLOSURES OR THE REPAYMENT CAPACITY OF THE BORROWERS. BEYOND THE FORMAL SITUATION OF THE LOANS, WHICH CAN BE EASILY MANIPULATED

4. PROPER AND PROMPT PROVISIONS TO COVER THE WHOLE OF THE LOSS THUS IDENTIFIED AND SUSPENSION INTEREST ACCRUAL ARE THE BEST PREVENTIVE MEDICINE. BUT THEY ARE THE ENEMY OF DIVIDENDS, EMOLUMENTS AND BONUSES FOR TOP MANAGEMENT AND EXTRAVAGANT EXPENDITURE. AN IMPORTANT REASON WHY THEY ARE AVOIDED BY BAD BANKERS

5. AS LONG AS NON-PERFORMING ASSETS – LOANS AND OTHER - ARE NOT IDENTIFIED AND PROMPTLY PROVISIONED TO COVER THE WHOLE OF THE INCURRED AND EXPECTED LOSS, THE BANKER WILL BE RELUCTANT TO SELL THEM BECAUSE THE UNDISCLOSED OR UNDER PROVISIONED LOSS WILL THEN MATERIALIZE.

6. WORSE, THE UNPROVISIONED PART OF THE NPA DOES NOT PROVIDE ANY YIELD. IT DOES NOT PERFORM. BUT THE LIABILITY THAT SUPPORTS IT INVOLVES A COST AND A CASH OUTFLOW. IN OTHER WORDS, THE NET INVOLVES A CURRENT LOSS AND A WORSENING OF LIQUIDITY. THIS HAPPENS CONTINUOUSLY, DAY AFTER DAY.

7. FINAL ILIQUIDITY WILL SHOW SUDDENLY, SPECIALLY IF LACK OF MARKET CONFIDENCE OR A SPECIAL EVENT ADDS TO THE DECAPITALIZATION EFFECT AND TRIGGERS PANIC. UNFORTUNATELY, ONLY THEN SUPERVISORS STEP IN. MEANWHILE INSOLVENCY HAS BEEN GROWING. TOO LATE AND TOO EXPENSIVE.

8. PROPER PRIVISIONS AND SUSPENSION OF ACCRUALS, WHEN TIMELY IMPOSED BY SUPERVISOR, ON A CASE-BY-CASE BASIS, PROVES THE MOST EFFECTIVE PREVENTIVE MEDICATION. THE SNOW BALL OF HIDDEN LOSSES WILL STOP ACCUMULATING AND GRADUAL REMEDIAL ACTION BY MANAGEMENT AND

SUPERVISORS WILL PROVE FEASIBLE AND EFFECTIVE. THERE WILL BE FEWER AND LESS SERIOUS CRISES

9. STRENGTHENING PROCEDURES AND GOVERNANCE SHOULD BE WELCOME, BUT SHOULD NOT REPLACE INSPECTION. WHY? THEY WILL NEED AN OVERALL CHANGE OF CULTURE THAT WILL ONLY TAKE PLACE IN THE LONG TERM. MEANWHILE, TOLERATING LAX PRACTICES, PARTICULARLY IN ASSET EVALUATION, WOULD PROVE MERELY COSMETICS AND A CONTRADICTION IN TERMS

10. TREATING DECAPITALIZATION OR INSOLVENCY JUST WITH ASSISTED LIQUIDITY SUPPORT, IN WHATEVER MODALITY, WILL NOT REFILL THE HOLE, SINCE BORROWED LIQUIDITY HAS TO BE REPAYED. AS SIMPLE AS THAT. LENDING OF LAST RESORT HAS TRADITIONALLY BEEN SHORT TERM AND COSTLY, AS AN INCENTIVE FOR CORRECTIVE ACTION BY MANAGERS OR SUPERVISORS.

11. ON THE CONTRARY, MASSIVE LIQUIDITY SUPPLIED BY CENTRAL BANKS AT ENDLESS TERMS AND AT LOW OR NO INTEREST RATES IN THE HOPE TO PROPEL INFLATION AND ECONOMIC RECOVERY AND TO IMPROVE NON-RECURRENT BANK RESULTS, MAY PROVE EFFECTIVE FOR A WHILE. BUT IF PERPETUATED, ITS POTENTIAL SIDE EFFECT MAY INVOLVE SERIOUS RISKS THAT SHOULD BE SERIOUSLY CONSIDERED. LET US THINK OF CHANGES IN THE BANKING BUSINESS MODELS, STAGNATION OF ROA (AS HAPPENS IN A NUMBER OF COUNTRIES), DEVELOPMENT OF BUBBLES AND ENCOURAGEMENT OF MORAL HAZARD LEADING TO OVEREXTENSION AND HIGH RISK. IT WOULD THEN PROVE TO BE A "FALSE FRIEND"

12. ANOTHER WARNING. FORBEARANCE OR AVOIDING STRICT REGULATION AND SHORT TERM SUPERVISION FOR THE SAKE OF HYPOTHETICAL STABILITY OF THE FINANCIAL SYSTEM OR THE ECONOMY MAY ALSO PROVE A “FALSE FRIEND”. CURRENT STABILITY IS VERY VULNERABLE. SUCH POLICY MAY BE TACITLY TRIGGERING A MORE SERIOUS CRISIS, SOONER RATHER THAN LATER

13. ANY FINANCIAL ENGINEERING MECHANISM - INCLUDING BAD BANKS – SHOULD BE AVOIDED IF IT FAVOURS COSMETICS AND BETS ON PROMPT RECOVERY OF THE PRICE OF BAD ASSETS. SUCH EXPECTATION MAY NEVER MATERIALIZE AND LACK OF PERFORMANCE, MAINTENACE AND MARKETING COST MAY MAKE IT A BAD OPTION

14. “BAD BANKS” – WHETHER JOINT OR INDIVIDUAL FOR GIVEN COUNTRIES – WILL ONLY PROVE EFFECTIVE AND TRANSPARENT UNDER THE FOLLOWING CONDITIONS:

- BE PRECEDED BY MANAGEMENT OVERHAUL, NOT TO FAVOUR BAD MANAGERS WHO CAUSED THE PROBLEM
- ENTIRE DECONSOLIDATION HAS TO BE ACHIEVED. WHETHER LEGALLY OR “DE FACTO”, DECONSOLIDATION IS THE ONLY CLEAN UP MECHANISM
- PRICING THE BAD ASSETS TO BE CARVED OUT – THE KEY OF A SUCCESSFUL OPERATION – SHOULD TAKE TIME. WHETHER PRICES ARE FIXED AT MARKET VALUE OR ABOVE, THE LOSS INVOLVED WILL REMAIN SOMEWHERE, I.E. IN THE CLEANED-UP INSTITUTION, OR PARTLY IN BOTH. THE BAD BANK AND THE CLEANED-UP BANK. THEREFORE, AS HAPPENED IN THE SCANDINAVIAN CRISIS OF THE 90’S, SUCH LOSS SHOULD BE RECAPITALIZED AUTOMATICALLY

BY THE SHAREHOLDERS OF THE BAD BANK AND/OR BY THE RESOLUTION MECHANISM. "A HOLE IS A HOLE" AND HAS TO BE REFILLED BY...WHOEVER

- THE TEMPTATION SHOULD BE AVOIDED TO INFLATE THE ASSET PRICE ON THE BOOKS OF THE "BAD BANK" IN ORDER TO SHOW A HEALTHIER PICTURE AND AVOID PROPER CAPITALIZATION. THIS WOULD INVOLVE COSMETICS AND BE AN OBSTACLE TO LIQUIDATION AT PRICES ABOVE MARKET

NOW, MY SUGGESTIONS

15. IN MY OPINION, THE BEST WAY TO FACILITATE THE LIQUIDATION OF NPL IS TO HAVE THEM VALUED IN THE BOOKS AT MARKET PRICE, SO THAT THEIR SALE WILL NOT MATERIALIZE ANY NEW LOSS

16. TO THAT EFFECT, NPL SHOULD BE FULLY PROVISIONED AS SOON AS THE POTENTIAL LOSS IS IDENTIFIED. A PHASE-IN PERIOD OF ONE OR TWO YEARS COULD BE ESTABLISHED. NO MORE.

17. WHEN LOANS WITH A REQUIRED PROVISION GO BEYOND 25% OF THE LOANS PRINCIPAL, INTEREST ACCRUALS SHOULD BE SUSPENDED RATHER THAN RECOGNIZED AS INCOME. THIS SUSPENSION SHOULD APPLY TO THE TOTAL PRINCIPAL AND NOT ONLY ON THE NONPROVISIONED PART OF THE LOANS. IN MY OPINION, IF A LOAN NEEDS TO BE PROVISIONED 50%, 75% OR 100%, THE BORROWER IS NOT REALLY PAYING INTEREST, UNLESS REFINANCED BY THE BANK. WHICH BOILS DOWN TO THE SAME

18. THE ABOVE SHOULD BE DONE AS A RESULT OF ON-SITE CASE BY CASE INSPECTION TO QUANTIFY THE LOSS INCURRED OR EXPECTED AND PROVISIONED COMMENSURATELY. OF COURSE, SAMPLING MECHANISMS SHOULD BE USED FOR THE LOW-VALUE ASSETS PORTFOLIOS, IN ORDER TO MAKE THE TASK LESS CUMBERSOME. THE ABOVE INSPECTIONS SHOULD LAST AS LONG AS NECESSARY AND SHOULD NOT LIMIT TO MATTERS OF PROCEDURE. ONE REALIZES THAT THIS KIND OF INSPECTION HAS BECOME UNFASHIONABLE BECAUSE IT IS MORE CUMBERSOME AND RESOURCES COMMITTING. BUT RECORDS ON MANY CRISES AND THE AMERICAN EXPERIENCE PROVE IT IS MORE EFFECTIVE AND LESS COSTLY
19. MODELS GROUPING LOANS OR ASSETS BY ECONOMIC SECTORS OR PRODUCTS SHOULD NOT BE TRUSTED. PRECISELY IF DESIGNED BY THE BAD BORROWER, THEY ARE NOT RELIABLE. ALL THE MORE SO WHEN THOSE MODELS ARE THE BASIS OF THEORETICAL STRESS TESTS. AT ANY RATE, THE TERMS OF A POTENTIAL PHASE-IN CALENDAR TO COVER EXPECTED LOSSES WITH PROPER LEVELS OF PROVISIONS SHOULD BE APPLIED TO THE ENTIRE PRINCIPAL OVER THE WHOLE DURATION OF THE LOAN. NOT JUST TO A SHORT PERIOD. IN OTHER WORDS, THE BOOKS WOULD SHOW THE LOSS TO BE INCURRED IF THE ASSET WAS LIQUIDATED AT THE TIME OF THE INSPECTION.
20. NOW, A CRUCIAL FEATURE OF THE MECHANISM PROPOSED IS THAT THE PROVISION ESTABLISHED FOR ASSET LOSSES, SHOULD BE CHARGED AGAINST P&L. THIS ALLOWS FOR A GRADUAL AWARENESS THAT THE BANK IS DETERIORATING, THUS ENCOURAGING AN IMPROVEMENT OF THE CREDIT POLICY AND AN ENCOURAGEMENT FOR THE MANAGEMENT AND THE SUPERVISOR TO GEAR REVERSE AND/OR APPLY CORRECTIVE ACTION

21. IT COULD BE SAID THAT LOSSES COULD BE OVERESTIMATED OR SUBJECT TO ANTICIPATED RECOGNITION AS A SMOOTHING MECHANISM. BUT THE RISK AND VULNERABILITY OF BANK'S BUSINESS REQUIRES THAT BAD THINGS TO BE RECORDED AS SOON AS THEY APPEAR ON THE HORIZON. IF THEY WERE TO BE TOTALLY OR PARTLY RECOVERED, THEY WOULD BE CREDITED ON THE P&L, AS MISCELLANEOUS INCOME. AT ANY RATE IT IS LESS RISKY TO OVERESTIMATE LOSSES THAN TO UNDERESTIMATE THEM. ALSO, CAPITAL CAN BE MANIPULATED AS WELL. THINK OF RWA OR THE SUSSCRIPTIONS FINANCED BY THE BANK

22. NOW, WHY NOT LET CAPITAL COVER THE LOSSES? IT CAN BE SAID THAT ESTIMATED LOSS AND PROVISIONS CAN BE MORE DISCRETIONAL AND SUBJECT TO CHANGE THAN COVERING THEM WITH CAPITAL. BUT IT IS NOT TRUE. TO ME, CAPITAL SHOULD BE THERE TO COVER "UNKNOWN UNKNOWNNS" IF THEY APPEAR IN THE FUTURE. IN THE MEANTIME, CAPITAL SHOULD BE CLEAN. IF CAPITAL IS USED TO COVER IDENTIFIED LOSSES YOU OVERESTIMATE THE GAINS, AND THEREFORE IS A CONTRIBUTION TO DECAPITALIZE BANKS. THE CAPITAL THUS INJECTED IS WELCOME, BUT IT IS BORN EMPTY AS REGULATORY CAPITAL

SINCE THAT PART OF THE CAPITAL IS ADSCRIBED TO COVER THE HOLE OF IDENTIFIED LOSSES, IT IS NOT NEW CAPITAL FROM A REGULATORY VIEWPOINT UNLESS THERE HAS BEEN A CAPITAL WRITE OFF TO THAT EFFECT. IT JUST VALIDATES THE FIGURE OF THE PREVIOUSLY EXISTING CAPITAL ON THE BOOKS

23. ALSO, ISSUING A CAPITAL INCREASE WHEN A BANK HAS A NEGATIVE NETWORTH, WITHOUT MAKING IT CLEAR TO POTENTIAL SUBSCRIBERS, SOUNDS LIKE A WAY TO CHEAT

THEM. REMEMBER THE FAMOUS PRINCIPLE: "DO NOT PUT GOOD MONEY ON BAD MONEY"

24. LET ME ADD THAT CAPITAL INCREASES CAN NOT BE ISSUED EVERY DAY AND THAT THE MARKETS ARE LIKELY TO BECOME SUSPICIOUS OF THE EXISTING WEAKNESS. AND SOONER OR LATER TRIGGER ADDITIONAL ILIQUIDITY

25. IN ANY CASE, IT IS VERY IMPORTANT TO REMEMBER THAT IF YOU COVER EXPECTED LOSSES WITH CAPITAL, RATHER THAN REDUCING PROFITS THROUGH PROPER PROVISIONING, YOU ARE FOSTERING THE BANKERS' MORAL HAZARD. THEY MAY CONTINUE TO MAKE BAD LOANS OR RESTRUCTURE THEM, MANAGEMENT SALARIES AND BONUSES WILL NOT BE ADJUSTED AND EXTRAVAGANT EXPENDITURES AND POLITICAL INFLUENCE WILL CONTINUE TO PREVAIL ALL AROUND

26. TO SUM UP. COMING BACK TO HOW TO BETTER LIQUIDATE NPLS, THE IDEAS AIRED HERE WILL MAKE THE LIQUIDATION OF THE NPL EASIER AT ANY TIME, SINCE THEY ARE BOOKED AT MARKET VALUE. THERE WILL BE NO NEW LOSS. INSTEAD, THE PROBLEM BANK WILL BECOME MORE LIQUID AND WILL FINALLY BE CLEANED UP. GIVING PRIORITY TO TIME IS ESSENTIAL. AS GENERAL MC ARTHUR USED TO SAY, "THE CAUSE OF ALL POLITICAL FAILURE IS ALWAYS LATE ACTION".